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IN THE

Supreme Court of the United States

OCTOBER TERM 1955

NO. 799

CLINT W. MURCHISON, JR., ET AL., *Petitioners*,

VERSUS

MARK DOTTENHEIM, *Respondent.*

PETITION FOR WRIT OF CERTIORARI

To The United States Court of Appeals
For The Fifth Circuit

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To The United States Court of Appeals
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Petitioners, Clint W. Murchison, Jr. and John Dabney Murchison, individually and as partners in the partnership firm of Murchison Brothers, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above case on December 13, 1955.

OPINIONS BELOW

The opinion of the District Court (R. 14-18) is reported in 131 F. Supp. 790. The opinion of the Court of Appeals is attached hereto as Appendix A and is reported in 277 Fed. 2d 737.

JURISDICTION

The judgment of the Court of Appeals, Appendix B attached, was entered on December 13, 1955. A Petition for Rehearing (ten copies filed herewith) was denied on January 17, 1956. On January 27th 1956, the Circuit Court stayed issuance of the mandate for a period of thirty days, provided there is filed with the clerk of said court a certificate of the clerk of the Supreme Court that certiorari petition and record have been filed. (Record p. 63). The jurisdiction of this Court is invoked under the provisions of 28 U.S.C.A. 1254 (1)

QUESTIONS PRESENTED

1. Does Rule 23(b), F.R.C.P., apply only to actions arising under diversity of citizenship despite the provision that the rules shall apply in all civil actions (except for those expressly excluded)?

2. Is the action of a shareholder suing on behalf of the corporation under Sec. 16(b) of the Securities Exchange Act of 1934 a secondary or derivative action and thus covered by Rule 23(b), F.R.C.P.?

3. Did Rule 23(b), F.R.C.P., and the repeal clause of the Rule-Making Statute actually have the effect of repealing earlier statutory procedure such as contained in Sec. 16(b) of the Securities Exchange Act of 1934?

STATUTES AND RULES INVOLVED

The pertinent portions of the federal statutes and of the federal rules involved in this suit are set out below:

Sec. 16(b) of the Securities Exchange Act of 1934 (15 U.S.C.A. 78p (b)) is as follows:

> (b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought

more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

The Securities Exchange Act of 1934 also provides (15 U.S.C.A. 78aa) as follows:

The district courts of the United States, the United States District Court for the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against

it in the Supreme Court or such other courts. June 6, 1934, c. 404, Sec. 27, 48 Stat. 902; June 25, 1936, c. 804, 49 Stat. 1921, June 25, 1948, c. 646, Sec. 32(b) 62 Stat. 991; May 24, 1949, c. 139, Sec. 127, 63 Stat. 107.

The Rule-Making Statute (28 U.S.C.A. Sec. 2072) reads as follows:

> The Supreme Court shall have the power to prescribe, by general rules, the forms of process, writs, pleadings, and motions, and the practice and procedure of the district courts of the United States and of the District Court for the Territory of Alaska in civil actions.
>
> Such rules shall not abridge, enlarge or modify any substantive right and shall preserve the right of trial by jury as at common law and as declared by the Seventh Amendment to the Constitution.
>
> Such rules shall not take effect until they have been reported to Congress by the Chief Justice at the beginning of a regular session and until after the close of such session.
>
> All laws in conflict with such rules shall be of no further force or effect after such rules have taken effect. Nothing in this title anything herein to the contrary notwithstanding, shall in any way limit, supersede, or repeal and such rules heretofore prescribed by the Supreme Court. June 25, 1948, c. 646, 62 Stat. 961, amended May 24, 1949, c. 139, Sec. 103, 63 Stat. 104; July 18, 1949, c. 343, Sec. 2, 63 Stat. 446.

Rule 1 of the Federal Rules of Civil Procedure reads as follows:

Rule 1. Scope of Rules

These rules govern the procedure in the United States district courts in all suits of a civil nature whether cognizable as cases at law or in equity, with the exceptions stated in Rule 81. They shall be construed to secure the just, speedy, and inexpensive determination of every action. As amended Dec. 29, 1948, effective Oct. 20, 1949.

Rule 23(b) and (c) of the Federal Rules of Civil Procedure reads as follows:

(b) Secondary Action by Shareholders. In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law and (2) that the action is not a collusive one to confer on a court of theUnited States jurisdiction of any action of which it would not otherwise have jurisdiction. The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort.

(c) Dismissal or Compromise. A class action shall not be dismissed or compromised without the approval of the court. If the right sought to be enforced

is one defined in paragraph (1) of subdivision (a) of this rule notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs. If the right is one defined in paragraphs (2) or (3) of subdivision (a) notice shall be given only if the court requires it.

STATEMENT

A. *The Basic Facts.* Dottenheim brought suit as a stockholder in Kirby Petroleum Company "in the name and in behalf of Kirby Pursuant to Sec. 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sec. 78p(b):" (Record p. 5). As the Circuit Court initially stated in its opinion, suit was brought on behalf of the corporation to recover alleged "short swing" profits from a "beneficial" owner of stock in the corporation under Sec. 16(b). Dottenheim alleged that Kirby Petroleum Company had failed to bring the action and that further demand would be futile, and that "Plaintiff has no adequate remedy at law." (Record p. 7). An accounting was sought with the amount thereof to be paid to Kirby Petroleum Company. (Record p. 8). Dottenheim did *not* allege that he owned any stock in the corporation at the time of the occurrence of the facts of which he complains.

B. *The Basic Issue.* A motion (Record pp. 9-10) was presented asking for dismissal of the petition on the ground that there was no allegation in the petition that Dottenheim owned any stock in Kirby Petroleum Co. at the

time the cause of action, if any, arose, and that there was consequently no compliance with Rule 23(b) F.R.C.P. The trial court sustained the motion and dismissed the complaint. (Record p. 22)

Thus was developed the basic issue as to whether Dottenheim suing as a stockholder on behalf of Kirby Petroleum and Sec. 16(b) of the Securities Exchange Act of 1934 "must allege that he was such stockholder at the time of the transactions complained of as required by Rule 23(b) of the Federal Rules of Civil Procedure in the case of 'an action to enforce a secondary right on the part of one or more shareholders. . .'" (quoted portion taken from Circuit Court Opinion - opening paragraph)

C. *The Decision of the Circuit Court.* The Circuit Court held in its opinion that the statute, 16(b), creates a new cause of action, which, although similar to, is actually not a secondary or derivative right at all. "It is in reality a primary right." "This is so because the statute which creates it makes it so." "The only actions referred to in the rules on which appellees so strongly rely are the equitable actions in which a stockholder is permitted to proceed on behalf of himself and others . . .". The Court further stated that this action was "not brought in federal court in diversity of citizenship grounds, but alleged that jurisdiction was 'invoked' under" . . . the Securities Exchange Act, and that the "only cause of action alleged must, therefore, of necessity have been the statutory right

established by the Securities Exchange Act." The Court observed that the parties and the trial court proceeded on the theory that the cause of action was created by the Securities Exchange Act and concluded that ". . . this law created a right in the plaintiff that is neither derivative nor secondary in the sense in which that term is used in the rule." (quoted portions are taken from Opinion of Circuit Court)

Federal Jurisdiction of Court of First Instance

The Federal District Court for the Northern District of Texas at Dallas had jurisdiction. It was invoked under Sec. 27 of Securities Exchange Act of 1934, 15 U.S.C.A. Sec. 78aa.

Reasons For Granting the Writ

A. The Circuit Court in this case has erroneously held, in effect, that Rule 23(b) F.R.C.P. applies only in cases where jurisdiction is based on diversity of citizenship of the parties. The rule says no such thing. To reach such a conclusion the Court went behind the actual language of the rule, for the rule is simple and plain in stating that the plaintiff must aver under oath that he *was a shareholder at the time of the transaction of which he complains.*

The predecessor of Rule 23(b) was the old Equity Rule 27. Still ahead of that was Equity Rule 94. But still ahead of old Equity Rule 94 was the Supreme Court opinion in

Dodge v. Woolsey, (1856) 15 L. Ed. 401. In that case the Court permitted a stockholder to maintain in Federal Court a suit on behalf of an Ohio corporation against Ohio officials on the theory that there was diversity between the plaintiff and the state officials. The defendant charged that this was a mere "contrivance" to give the Court jurisdiction. By the time the Supreme Court reached *Hawes v. Oakland*, (1882) 104 U.S. 450, 26 L. Ed. 827, it was apparently ready to fix and make definite the rule to be followed in such actions, for immediately after rendering its decision it promulgated Equity Rule 94. This constituted a substantial change, for now the burden was placed on the plaintiff to negative the existence of any collusive claim of jurisdiction. Equity Rule 94 required that the petition aver under oath that the suit was not a collusive one for the purpose of vesting the Federal Courts with jurisdiction.

At the time of the *Dodge v. Woolsey* case there was no statutory authority for dismissal of a suit in which jurisdiction was collusively created between the shareholder and his corporation. 28 U.S.C.A. Sec. 1359 was derived from Act of March 3, 1875, 18 Stat. 472, and it directly prohibited the establishment of jurisdiction by collusion. Hence the statutory law provided entirely different conditions at the time of the decision in the *Hawes v. Oakland* case. That portion of old Equity Rule 94 which required the pleader to negative collusive jurisdiction only implemented the statutory law on the subject.

It would appear that there would be no necessity to negative collusive claim of jurisdiction in cases involving federal questions. However, it has been stated:

> "While it has been held that this requirement has no application to those suits predicated upon a federal right—for here, whether the corporation *or* the shareholder sues, the federal court has jurisdiction because of the type of action, nevertheless, the Rule literally covers all secondary actions, regardless of the jurisdictional basis, and careful practice dictates that it be complied with." (Moore's Federal Practice, p. 3493, Vol. 3, Second Ed.)

The first clause of old Equity Rule 94, as well as later Rule 27, required allegations under oath that the plaintiff was a stockholder at the time of the transaction of which he complained. Only two years after the *Hawes* case the Supreme Court indicated by dicta that this provision was an independent requirement and was a rule of substantive law. *Dimpfell v. Ohio & M. R. Co.* (1884) 110 U.S. 209, 3 S. Ct. 573, 28 L. Ed. 121. The Court demonstrated a keen understanding of human nature that is as true in 1956 as it was in 1884:

> ". . . for aught we can see to the contrary, they (the plaintiffs) may have purchased the shares long afterwards, expressly to annoy and vex the company, in the hope that they might thereby extort, from its fears, a larger benefit than the other shareholders have received or may reasonably expect from the purchase, or compel the company to buy their shares at prices above the market value. Unfortunately liti-

> gation against large corporations is often instituted by individual shareholders from no higher motive."

Judge Roscoe Pound, later to become Dean, sitting in the case of *Home Fire Ins. Co. v. Barber* (1903) 93 N.W. 1024, in discussing the federal rule concluded that the rule must have its basis in non-jurisdictional matters; that it rests "in a sound and wholesome principle of equity."

The Supreme Court in a more recent case (1908) demonstrated plainly that the *Hawes* case is the landmark in the development of these rules. (*Venner v. Great Northern Ry.*, 209 U.S. 24, 28 Sup. Ct. 328).

> "Neither the rule nor the decision from which it was derived deals with the question of the jurisdiction of the courts but only prescribes the manner in which the jurisdiction shall be exercised. If a controversy of this general nature is brought in the Circuit Court and the necessary diversity of citizenship exists, but upon the pleadings or the proof it appears that the plaintiff has not shown a case within the decision of Hawes v. Oakland, or the rule of court declaratory of that decision, the bill should be dismissed for want of equity and not for want of jurisdiction. So it was in Hawes v. Oakland, the demurrer was sustained and the bill dismissed, not for want of jurisdiction, but, in the words of the court (p. 462) 'because the appellant shows no standing in a court of equity—no right in himself to prosecute this suit.'"

This *Venner* case involved a failure of stockholder to allege that he owned the stock at the time of the transaction. His position was that old Equity Rule 94 (which

later became Rule 27) related to jurisdiction in diversity cases. The Court rejected such position and again affirmed that the rule is a principle of equity—not a question of jurisdiction.

It is when the historic doctrine of *Erie Railroad Company v. Tomkins*, 304 U.S. 64, is injected that things begin to get sticky. If, as the Circuit Court here seems to contend, Rule 23(b) relates and applies only to diversity cases, that is, cases which arise under state law and reach the federal courts only on diversity of citizenship, does the state common law govern under the *Erie* case? If Rule 23(b) is a substantive rule of law, what happens in the collision with the *Erie* case?

The Circuit Court in *Cohen v. Young* (CCA 6th 1941) 4 Fr. Serr 23b.1, Case 3(opinion subsequently set aside) expresses its confusion and displeasure in these words:

> "Whether the doctrine of Erie R. Co. v. Tompkins will lead ultimately to a modification of the rule or to recognition of the right as one of substantive law to be controlled by state statutes or decisions, is beyond our ability to forecast, not being endowed by the gift of prophesy. We still conceive it to be our function to apply the law as we find it." (Moore's Federal Practice, p. 3497, Vol. 3, Second Ed.)

However, this Court, in *Cohen v. Beneficial Industrial Loan Corp.*, 69 Sup. Ct. 1221, speaking through Justice Jackson had no doubt whatever about the validity of Rule 23 (b):

"It is urged, however, that Federal Rule of Civil Procedure No. 23 deals with plaintiff's right to maintain such an action in federal court and that therefore the subject is recognized as procedural and the federal rule alone prevails. Rule 23 requires the stockholder's complaint to be verified by oath and to show that the plaintiff was a stockholder at the time of the transaction of which he complains or that his share thereafter devolved upon him by operation of law. *In other words, the federal court will not permit itsef to be used to litigate a purchased grievance or become a party to speculation in wrongs done to corporations.* It also requires a showing that an action is not a collusive one to confer jurisdiction and to set forth the facts showing that the plaintiff has endeavored to obtain his remedy through the corporation itself. It further provides that the class action shall not be dismissed or compromised without approval of the court, with notice to the members of the class. *These provisions neither create nor exempt from liabilities,* but require complete disclosure to the court and notice to the parties in interest. None conflict with the statute in question and all may be observed by a federal court, even if not applicable in state court." (Italics ours)

The question was dealt with in *H. F. G. Co. v. Pioneer Publishing Co.* (CCA 7th) 162 F (2) 536:

"Thus, the rules having been prescribed by the Supreme Court, as rules of procedure under the limitation imposed by Congress that the substantive rights of any litigant should not be altered, it would appear that one who asserts that this rule (or any rule) deals with matters of substantive law rather than procedure carries a heavy burden. Also, we are of the

view that a strong presumption exists that the Supreme Court in prescribing the rules acted within the power delegated to it by Congress, and that the Court and Congress, as well as others who labored in connection therewith, thought that the rule in question was one of procedure and that its adoption would not affect the substantive rights of any litigant."

The opinion in the *Pioneer* case demonstrates an understandable reluctance to assume the position of correcting "mistakes" in the Rules promulgated by the Supreme Court:

> "Furthermore, we think that the determination as to whether a mistake has been made in this respect can more appropriately be made by the Supreme Court, which is given the power to amend."

The Advisory Committee in the Final Draft of Amendments of 1946 discussed in its notes to Rule 23 (b) whether clause (1) can be applied by a federal court in a state whose law is contra:

> "There is reason to say that the question is one which should not be decided by the Supreme Court *ex parte*, but left to await a judicial decision in a litigated case, and that in the light of the material in this note, the only inference to be drawn from a failure to amend Rule 23(b) would be that the question is postponed to await a litigated case.
>
> ". . .
>
> "If, however, the final conclusion is that the rule deals with a matter of substantive right, then the rule should be amended by adding a provision that Rule 23(b) (1) does not apply in jurisdictions where

state law permits a shareholder to maintain a secondary action, although he was not a shareholder at the time of the transactions of which he complains." (Moore's Federal Practice, p. 3501, Vol. 3, Second Ed.)

There are still two more powerful factors which must be added to an already confusing complexity of thought. These are:

(1) Tit. 28, U.S.C.A. Sec. 2072, grants the rule-making power to the Supreme Court. Among other provisions:

"Such rules shall not abridge, enlarge or modify any substantive right . . ."

"All laws in conflict with such rules shall be of no further force or effect . . ."

(2) Rule 1 says the rules shall govern "*in all* suits of a civil nature whether cognizable as cases at law or in equity with the exceptions stated in Rule 81." "They shall be construed to secure the just, speedy, and inexpensive *determination of every action.*" (Italics ours)

It is clear from the above that true substantive rights cannot be effected by the rules. If a rule is held to be substantive in nature, can it exist in the face of the very statute which created the rule-making power? Although we must in candor concede that there is much confusion

and uncertainty in some of the authorities, we submit that Rule 23(b) is procedural. It neither creates nor destroys *any substantive right.* It deals solely with *how* that substantive right shall be administered by the courts.

If Rule 23(b) can apply only to cases arising under state law and reaching the federal court on diversity, then what does "in *all* cases of a civil nature" and "determination of *every* action" mean? It must have some meaning. Can it be that this rule means all cases which arise only under state law and reach the federal court by diversity? This would indeed be odd if the federal rule should apply only to cases arising under state law and have no application to cases arising under federal law. If the state law could be said to be substantive, then the federal rule would presumably, under the *Erie* case, be wholly impotent. It would then apply in *no* case.

It is our firm conviction that the endless confusion and complexity surrounding Rule 23(b) should be erased by a definite opinion of this Court. It cannot be done by any other court or agency. It rests exclusively within the province and responsibility of this Honorable body.

There are several cases which undertake to deal with the application of Rule 23(b) to cases arising under 16 (b) of the Securities Exchange Act, and they only extend, magnify and amplify the confusion. For example:

In *Pellegrino v. Nesbit,* 203 F (2) 463, the Court says that Congress never could have intended that compliance

with Rule 23(b) was a prerequisite. Obviously so. It couldn't. Rule 23(b) was not in existence when Congress passed Sec. 16(b) of the Securities Exchange Act. Congress, in creating the rule-making power, *repealed all laws* in conflict with all of the rules and that included Sec. 16(b) if it conflicts. What Congress intended when it passed Sec. 16(b) is immaterial, but what is material is what it intended when, years later, it repealed *all* laws in conflict with the rules made under the rule-making statute.

In *Blau v. Mission Corp.*, 212 F (2) 77 the court stated that Rule 23(b) "cannot, even if so perhaps intended, override the direct mandate of Sec. 16(b) . . ." Apparently 16(b) is a statute which not even Congress can repeal! Surely that court didn't intend to hold that there is any statute which cannot be repealed. Apparently the court was not aware of Tit. 28, U.S.C.A. Sec. 2072, and its blanket repeal clause in favor of the rules.

The only other case cited before the Circuit Court by the appellant as being precisely in point is a District Court case (*Benisch v. Cameron*, 81 F. Supp. 882). It does not undertake to explain how the older statute (16(b)) overrides all else.

We believe the language used in the case of *Winsor v. Daumit*, 179 F (2) 475, plainly and concisely states what must surely be the sound and reasonable view:

> "The rules were promulgated under the Act of June 19, 1934, c. 651, secs. 1 and 2, 48 Stat. 1064,

U.S.C. Title 28, secs. 723b, 723c (now 28 U.S.C.A. art. 2072), whereby Congress conferred upon the Supreme Court the power to prescribe, by general rules, for the district courts of the United States, the 'form of process, writs, pleadings, and motions, and the practice and procedure * * * in civil actions.' The court reported to the Congress, through the Attorney General, that it had adopted the original rules and, later, the amendments thereto. 'Congress, having taken no positive action in connection therewith, under the statute * * *, the rules became effective. * * * That Congress was familiar with the rules as transmitted to it, must at least, be assumed. * * * it must also be assumed that Congress, by its non-action, construed the rules as being within the power conferred.' Sibbach v. Watson & Co., Inc., 7 Cir., 108 F. 2d 415, 416; reversed on other grounds in Sibbach v. Wilson & Co., 312 U.S. 1, 61 S. Ct. 422, 427, 85 L. Ed. 479. In the latter case the Supreme Court said: 'Evidently the Congress felt the rule was within the ambit of the statute as no effort was made to eliminate it.'"

The court expressed what seems to us is the only proper attitude for every court to take:

"(2-3) *The rules, therefore, have the force and effect of statutes, and if there is conflict between a procedure provided in an earlier act of Congress and that provided by the rules, the former must yield to the latter*, for the act of Congress under which the rules were authorized expressly provided that, after they became effective, any laws in conflict therewith would no longer be of any force or effect. John R. Alley & Co. v. Federal Nat. Bank, 10 Cir., 124 F. 2d 995. It would seem to follow that, though it adds cer-

> tain conditions precedent to the appealability of certain orders of the district court in addition to those previously existing, *the rule, possessing the effect of a statute, must, under the provisions of the act authorizing it, take precedence over the former procedure. We might add that, even though we thought otherwise, we would not, in advance of the Supreme Court's so declaring, hold that the court had overreached its authority in adopting the rule.*" (Italics ours)

Here again we find the bench and bar looking to the Supreme Court for its determination of the meaning and effect of the Rules:

> "The Supreme Court quite properly did not amend Rule 23(b); apparently it preferred to take no *ex parte* action but rather to allow the matter to be decided in a litigated case." (Moore's Federal Practice, p. 3501, Vol. 3, Second Ed.)

May we respectfully suggest that the entire matter of Rule 23(b) could be decided in *this* litigated case.

The subject matter of this litigation is highly important. The entire industrial might of this great nation must flow through corporations. This is the American scheme of things. Certainty of procedure in secondary and derivative suits against corporations is more important today than ever before in history.

Rule 23(b) is weighed down with antecedents which extend back for over 100 years. These antecedents and the many cases interpreting them still haunt the modern-day interpreter. In fact, the most common reason advanc-

ed for construing Rule 23(b) to be restricted in its application is that more than a century ago its antecedent (Rule 94) was thought to have been promulgated to stop collusive jurisdiction. But the second averment required by the Rule deals with this, not the first averment, which deals with stock ownership.

We are reminded that a good rule, like a good ship, acquires barnacles. This is the inevitable result of time. No one barnacle is important, but the accumulation of them over an extended period of time is disabling. With the ship we scrape them off, and we do it periodically. With the rule we save, preserve and protect it for 100 years if necessary.

The Supreme Court can expeditiously make certain *any* problem of procedure. We submit that it would be an outstanding service to the bench, the bar and the nation to clean up the morass that has surrounded Rule 23(b). We can think of no rule of law that is in such a deplorable state.

B. The Circuit Court held in this case that Sec. 16(b) of the Securities Exchange Act created "*a primary right.*" To be certain that there would be no misunderstanding, it restated it in the negative: "that this law created a right in the plainitff that is *neither derivative nor secondary* in the sense in which that term is used in the Rule." (Italics ours)

It is our view that this holding is patently in error. Even the *Benisch v. Cameron* case (81 F. Supp. 882) relied on by the Circuit Court says that the suit "is in behalf of the issuer rather than for the personal benefit of the stockholder plaintiff."

It is held that a shareholder who fails to comply with Rule 23(b) has no standing to assert, on behalf of his corporation, a right created by a federal statute which authorized the filing of a review proceeding in the United States Court of Appeals. The Public Utility Holding Act of 1935, 15 U.S.C.A. Sec. 79X(a), authorizes the filing of a petition to review orders of the S. E. C. by "Any person or party aggrieved by an order issued by the commissioner . . ." In *Okin v. Securities and Exchange Commission*, 143 Fed. 2d 943, Okin was a shareholder in a holding company whose subsidiary held stock in Florida Power & Light Co. The commission issued an order against the Florida Company and Okin, though not a party to the proceeding, filed a petition in the U. S. Court, under the statute, to review the order. The court held that the stockholder's action was derivative and that he had no standing because he failed to comply with Rule 23(b) and the equitable principle it contains. The court says:

> *"Thus any cause of action he asserts is derivative, not individual, since he does not claim to suffer any damages peculiar to himself or different in kind from damages sustained by all common shareholders of Electric."* (Italics ours)

And also:

> "Okin's petition shows no efforts to satisfy the conditions of the rule under which shareholders may sue derivatively on behalf of their corporation. See Hawes, City of v. Oakland, 104 U. S. 450, 26 L. Ed. 827; United Copper Securities Co. v. Amalgamated Copper Co., 244 U. S. 261, 37 Sup. Ct. 509, 61 L. Ed. 1119; *F.R.C.P. Rule 23(b), 28 U.S.C.A.* following section 723(c). It is now too late for that defect to be cured. Consequently the motion to dismiss is granted." (Italics ours)

The Supreme Court has said in *Price v. Gurney*, 324 U.S. 100, 65 Sup. Ct. 513 that:

> "A derivative action is a suit by a shareholder to enforce a corporate cause of action. The corporation is a necessary party to the suit. And the relief which is granted is a judgment against a third person in favor of the corporation."

The plaintiff Dottenheim alleges that the defendants are accountable to the corporation—not to him. He prays that the corporation recover—not the plaintiff. How can the plaintiff have a "primary right." He has no right except to act on behalf of the corporation on a cause which he concedes rests in the corporation. If the corporation owns the only cause of action, the position of plaintiff is obviously derivative and secondary.

This is in accord with such authorities as Moore's Federal Practice (Second Edition, Vol. 3, p. 3508) where Rule 23(b) is discussed. It was said:

> "Suits which are said to be derivative, and therefore come within the rule, are those which seek to enforce any right which belongs to the corporation and is not being enforced, such as the liability of corporate officers or majority shareholders for mismanagement, to recover corporate assets, to enforce rights of the coropration by virtue of its contract with a third person, and to enjoin those in charge of the corporation from causing it to commit an ultra vires act."

The shareholder's action is derivative and not primary even though the suit asserts a federally created cause of action on behalf of the corporation. In *Franchon v. Marco, Inc. v. Paramount Pictures, Inc.*, 202 F. 2d 731, a suit was filed by a stockholder under the federal anti-trust statutes The court held that it was a derivative suit and:

> "Shareholder's right to sue in the corporate stead must first be established."

In *Koster v. Lumberman's Mutual Casualty Co.*, 330 U.S. 518, 67 Sup. Ct. 828 (cited by the Circuit Court in the present case) the court commented:

> "The cause of action which such a plaintiff brings before the court is not his own but the corporation's. It is the real party in interest and he is allowed to act in protection of its interest somewhat as a 'next friend' might do for an individual . . ."

Goldstein v. Groesbeck, 142 F. 2d 422, involved a suit under the Public Utility Holding Company Act where the court said:

> ". . . the District Court erred in holding the present type of suit not a derivative action on behalf of the corporation within the statute."

Frankly, we are unaware of any case holding that the right of a stockholder to sue on behalf of the corporation is *primary* and that it is *not secondary nor derivative.* We submit that the opinion of the Circuit Court is wholly unsupported by any authority. Actually it is a novel concept which only adds confusion to the whole question of Rule 23(b).

C. The Circuit Court refused to answer directly the keystone question in this case. Is the repealer clause effective when it unequivocally decrees that "all laws in conflict with such rules shall be of no further force and effect after such rules have taken effect." The Circuit Court seeks to sidestep this bothersome statute by concluding that there is really no conflict in the provisions of Sec. 16(b) and Rule 23(b). *Actually 16(b) does not provide whether the stockholder must be such at the time of the transaction complained of or not.* It simply says that suit "may be instituted either at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer . . ." Compare with Rule 23(b) which says simply that the shareholder shall state under oath that he "was a shareholder at the time of the transaction . . ." It is our view that the language used is plain and unambiguous and requires no extended judicial construction unless one wishes to escape from the plain import of the common and ordinary words used.

But, *if*, as the Circuit Court contends, 16(b) does not require the stockholder to be such at the time of the transaction—how can the provisions of Rule 23(b), which say exactly the opposite, be anything but in "conflict." If there is no conflict, as the Court says, then why not apply the specific language of Rule 23(b)?

Another puzzling piece of judicial construction is demonstrated in the quote from *Blau v. Mission*, 212 F. (2) 77: Speaking of Rule 23(b), as well as the state law, the court says:

> "* * * those provisions directed particularly to shareholders derivative action to recover for misdeeds of corporate officials, *cannot, even if so perhaps intended, override the direct mandate of Sec. 16(b)*, that suit may be brought 'by the owner of any security' without qualification. * * *"

In other words Rule 23(b) even though it has the force and effect of statutory law in the repealer clause, cannot distrub the so-called mandate of 16(b) that suit may be brought by the owner of any security without qualification. Of course 16(b) doesn't say "without qualification". It simply does not state any qualification one way or the other, but in the hands of the writer of the Blau opinion, this failure to state any qualification becomes part of a "direct mandate" which overrides the specific qualifications of Rule 23(b). This is all quite puzzling, but the Circuit Court in our case said that it is "not clear whether the court based its decision on the inefficacy of

the Rule-Making Statute to repeal the specific provisions of a *conflicting statute*, or on some other ground." But, the Circuit Court by-passes this most troublesome and confusing problem by saying that it doesn't reach the question because *there is no conflict* between the rule and what it had just referred to as "a conflicting statute".

It is inescapable that there must be either: (1) A conflict between the rule and the statute, or; (2) no conflict between the two. If there is a conflict, the repealer clause certainly disposed of prior laws in conflict. If there is no conflict, certainly no reason can be assigned why Rule 23(b) should not be followed.

We suggest that probably *Blau v. Mission* looked upon Rule 23(b) as just a court rule which was expressly subordinate to all statutory law prior to the Rule-Making Statute. It neglected to consider that Rule 23(b) has all the force of statutory law as far as 16(b) is concerned.

There would seem to be no question about the effect of the Rule-Making Statute. If the case of *Winsor v. Daumit*, (179 Fed. (2) 475) states the correct rule, and it undoubtedly does, then it is settled that:

> "• • • The rules, therefore, have the force and effect of statutes, and if there is confict between a procedure provided in an earlier act of Congress and that provided by the rules, the former must yield to the latter, for the act of Congress under which the rules were authorized expressly provided that, after they became effective, any laws in conflict therewith would

no longer be of any force or effect. John R. Alley & Co. v. Federal Nat. Bank, 10 Cir., 124 F. 2d 995. * * *"

We think it inescapable that *Blau v. Mission* and *Winsor v. Daumit* are irreconcilably in conflict and that this conflict demonstrates the utter fallacy of *Blau v. Mission* as well as the opinion in the instant case.

There has been little said about the real purpose of Rule 23(b). Most cases have been so involved in the technical construction to be divined from the history of the rule and its antecedents, that rarely do we find any mention of the wholesome principles of equity that have always required that the stockholder be such at the time the cause of action arose. Justice Jackson, in *Cohen v. Beneficial Industrial Loan Corporation*, 69 Sup.Ct. 1221, bluntly states what rule 23(b) means to him:

> *"In other words, the federal court will not permit itself to be used to litigate a purchased grievance or become a party to speculation in wrongs done to corporation."* (Italics ours)

If this is the legitimate purpose of Rule 23(b), does it obtain with any less validity in a "federal question" case as distinguished from a "diversity" case, or a case airsing under 16(b) as distinguished from a case arising under a similar type of state law? Obviously not!

CONCLUSION

It is our firm conviction that Rule 23(b) is plain and unambiguous. We believe it should mean just exactly

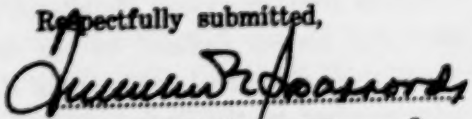
what it says—no more—no less. That no court, except the Supreme Court alone, should have the power to add to or take away from it. That if many of the rules suffer the fate of Rule 23(b) they will completely lose their value, for they become only platforms for extensive and ofttimes obtuse judicial construction by different courts to different ends.

The petition in the instant suit was signed and sworn to in New York, filed in the Federal District Court in Dallas, against Dallas defendants and on behalf of a Delaware corporation. Although Dottenheim does not specifically allege that he resides in New York, apparently complete diversity exists. He alleges in detail the *reasons* why any further demand on the corporation would be futile, this being lifted bodily out of Rule 23(b) and in nowise required by the language of 16(b). He alleges that he has no adequate remedy at law, which allegation is certainly not required if his cause is a purely statutory suit for money. He asks for an accounting which is a purely equitable remedy not provided for in 16(b). Sec. 16(b) authorizes a suit either at law or equity. If equity is deliberately and obviously chosen, are the rules and principles of equity not also chosen? This surely should be the case. Congress certainly didn't contemplate the authorization of a suit in equity wholly apart and free from established equity principles. Old Equity Rule 94, then Rule 27 and now Rule 23(b) have preserved, without a gap for more than a period of 100 years, the whole-

some equitable concept that you cannot purchase stock *after* a transaction and then complain about the corporation *in a court of equity*. The rule itself has never changed. Why should the mere passage of time so dull its significance that some of our courts should treat it so lightly, unless during this passage of time we, as a people, have become less and less conscious of moral principle and more and more impressed by sterile legal jargon.

The Circuit Court here has injected further uncertainly and inconsistency in a field already replete with contradictions and misunderstanding. The petition for writ of certiorari should be granted that justice may be done.

Respectfully submitted,



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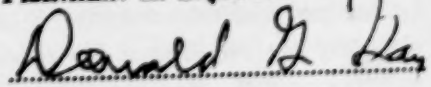

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AFFIDAVIT OF SERVICE OF PETITION FOR WRIT OF CERTIORARI

BEFORE ME, the undersigned authority, a Notary Public in and for Dallas County, Texas, on this day personally appeared Donald G. Gay, who, being by me duly sworn, upon his oath deposes and says that on the 22nd day of ~~February~~ March, 1956, he delivered to Mr. Harold B. Sanders and Mr. Barefoot Sanders, 1625 Kirby Bldg., Dallas, Texas, attorneys for respondent in the above cause, a true copy of the foregoing petition for writ of certiorari to the United States Court of Appeals for the Fifth Circuit.

Donald G. Gay

Donald G. Gay

Subscribed and sworn to before me by the said Donald G. Gay this 22nd day of ~~February~~ March, 1956, to certify which witness my hand and seal of office.

Dorothy Wright

Notary Public in and for
Dallas County, Texas

APPENDIX A

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 15506

MARK DOTTENHEIM,

Appellant,

versus

CLINT W. MURCHISON, JR., ET AL.,

Appellees.

Appeal from the United States District Court for the Northern District of Texas.

(December 13, 1955.)

Before TUTTLE, CAMERON and JONES, Circuit Judges.

TUTTLE, Circuit Judge: We are here called upon to determine whether a stockholder who sues on behalf of his corporation to recover "short-swing" profits of a

"beneficial" owner of stock in the corporation, as authorized under Section 16(b) of the Securities Exchange Act of 1934,[1] must allege that he was such stockholder at the time of the transactions complained of as required by Rule 23(b) of the Federal Rules of Civil Procedure in

---

1 Sec. 16.(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (and a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection. (Emphasis supplied)
15 U.S.C.A. Sec. 78 p (a) and (b).

the case of "an action brought to enforce a secondary right on the part of one or more shareholders. . ."[2]

The trial court decided this question in the affirmative and dismissed the complaint which sought recovery of profits allegedly reaped by the individual defendants from purchase and sale of stock in the defendant Kirby Petroleum Company, in which they owned more than 10% of the common stock, the said stock being listed on the American Stock Exchange in New York, a national securities exchange.

Appellant, citing *Blau v. Mission Corp.*, 212 F. 2d 77, 79 (C.A. 2, 1954), cert. den. 347 U.S. 1016; *Pellegrino v. Nesbit*, 203 F. 2d 463, 466 (C.A. 9, 1953); and *Benisch v. Cameron*, 81 F. Supp. 882 (D.C., S.D.N.Y., 1948), asserts that these are the only court decisions precisely in point, and that they all support his thesis that Rule 23(b) does not apply to an action brought by a security holder under Section 16(b) of the Securities Exchange Act.

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2 F.R.C.P. Rule 23(b) SECONDARY ACTION BY SHAREHOLDERS. In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share hereafter devolved on him by operation of law and (2) that the action is not a collusive one to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction. The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees, and if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort.

Appellees, conceding that these are the only judicial pronouncements on the point in issue, say, first, that these cases are bad law, and they then conclude by characterizing them as an abandonment of "the morality of which the equity rules and the FRCP were born," resulting from either "zeal for social ideology or other misguided motives." Such extravagance of expression detracts from what is otherwise an excellent exposition of appellees' theory of the law.

The rules of law applicable to this case are neither complicated nor unusual. The statute here involved creates a new cause of action, which, while similar in some respects to a secondary or derivative right, is not such a right at all. It is in reality a primary right. This is so because the statute which creates it makes it so. The only actions referred to in the rules on which appellees so strongly rely are the equitable actions in which a stockholder is permitted to proceed on behalf of himself and others similarly situated to compel a corporation to take action against those who, by reason of their control of the corporate machinery or corporate policies, are abusing their position of trust or are taking advantage of inside knowledge for their own benefit. This type of action, long recognized as a creature of equity, was described by Mr. Justice Jackson in his opinion in *Koster v. Lumbermens Mutual Co.*, 330 U.S. 518, where on page 522 he said:

> "The stockholder's derivative action, to which this policyholder's action is analogous, is an invention of

> equity to supply the want of an adequate remedy at law to redress breaches of fiduciary duty by corporate managers. Usually the wrongdoing officers also possess the control which enables them to suppress any effort by the corporate entity to remedy such wrongs. Equity therefore traditionally entertains the derivative or secondary action by which a single stockholder may sue in the corporation's right when he shows that the corporation on proper demand has refused to pursue a remedy, or shows facts that demonstrate the futility of such a request. With possible rare exceptions, these actions involve only issues of state law, and, as in the present case, can get into federal courts only by reason of diversity in citizenship of the parties. Their existence and peculiar character were recognized by this Court in the old Equity Rules. Rule 27, 226 U.S. 656."

It should be observed here that the complaint in the case before the court was not brought in the federal court on the diversity of citizenship grounds, but it alleged that jurisdiction was "invoked under Section 27 of the Securities Exchange Act of 1934." Such jurisdiction was not challenged by appellees. There being no allegation of diversity of citizenship as between plaintiff and defendants, the only cause of action alleged must, therefore, of necessity have been the statutory right established by the Securities Exchange Act.

That this is an entirely new cause of action created by the statute is further demonstrated by the terms of §78aa, which provide that the District Courts of the United States shall have exclusive jurisdiction of viola-

tions of Section 78, and of all suits "brought to enforce any liability or duty created" thereby. There is, of course, no such provision as to anordinary secondary or derivative action by a stockholder, which, as pointed out by Mr. Justice Jackson above, is ordinarily based on state jurisprudence. The plaintiff below, the defendants and the Court all proceeded on the theory that the cause of action sued on was created by the Securities Exchange Act. This being so, we take the same view of it, and find that this law created a right in the plaintiff that is neither derivative nor secondary in the sense in which that term is used in the Rule.

Appellees contend that Rule 23(b), requiring that in secondary actions by stockholders, the complaining party must allege stock ownership at the time of the transaction of which he complains, was adopted with the force of law subsequent to the passage of the Securities Exchange Act and that the repealer section of the Rule-Making Statute struck down any conflicting prior law;[3] that there is a conflict between the rule and the prior statute and that the statute must yield to the rule. The fallacy of this argument is that, as we construe the statute and the rule, there is no conflict. This is implicit in the court's opinion in the Pellegrino case, *supra*.[4]

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3 28 U.S.C.A. (1927) Sec. 723(b), now 28 U.S.C.A. (1948) Sec. 2072, provides that "all laws in conflict with such rules shall be of no further force and effect after such rules have taken effect."

4 There, although the precise question was not before the court for decision, it was said:

In the case of *Benisch v. Cameron, supra,* the District Court for the Southern District of New York passed on this precise point and held that such a suit is not subject to the procedural requirements of the Rule 23(b) (5).[4]

"Section 16(b) establishes a statutory policy intended to prevent the abusive practices which were found to result from short-swing insider trading of securities, practices which are harmful both to the other stockholders and to the general public. See Sen. Rep. No. 1455, 73 Cong., 2d Sess. (1934). To the extent the statute is intended to protect the public from market fluctuations intentionally caused by or within the prior knowledge of corporate insiders seeking short-swing profits, the plaintiff in a sec. 16(b) suit is merely an instrument for effectuating the statutory policy. The statute states that where an issuer fails to bring suit within sixty days after request or fails diligently to prosecute the same thereafter 'the owner of any security of the issuer's (Italics ours) may institute suit. Such suit is 'in behalf of the issuer' rather than for the personal benefit of the stockholder plaintiff. Thus the stockholder need not have owned stock at the time the transaction of which he complains took place. Benisch v. Cameron, D.C.S.D.N.Y. 1948, 81 F. Supp. 882 . . . ."
Pellegrino v. Nesbit, 203 F. 2d 463, 466

"Although the right of action created by Section 16(b) is somewhat akin to the ordinary stockholder's derivative suit, it is plain primarily intended as an 'instrument of a statutory policy of Section 78b, and in the preamble to Section 16(b), that it was from the reasons set forth in Section 2 of the Act, 15 U.S.C.A. which the general public is the ultimate beneficiary. Congress did not intend procedural restrictions to hamper such policy.
" 'A further manifestation of this purpose is evident from the fact that suit might be instituted by any 'security' holder of the issuer. And 'security' is defined in Section 3, 15 U.S.C.A. Section 78c, as 'any note, stock, treasury stock, bond, debenture, certificate of interest, or participation in any profit-sharing agreement or in any oil, gas or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrumen commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.'
"Congress, therefore, could never have intended compliance with Rule 23(b) as a prerequisite to suit because the 'security' holders authorized to sue under 16(b), other than a shareholder, cannot, by reason of their status, make the averment required by Rule 23(b)."
Benisch v. Cameron, D.C., S.D.N.Y., 81 F. Supp. 882,884.

In *Blau v. Mission Corp, et al, supra,*[6] also relied on by appellant, the court dealt with this matter. It lightly brushed aside the contention there made that Rule 23(b) was applicable to a situation like the present. The opinion stated:

> "The complaint is not defective for failure to allege that plaintiff was a shareholder at the time of the transaction complained of in accordance with Fed. Rules Civ. Proc., Rule 23(b) and Del. General Corporation Law, 8 Del. C. §327; those provisions directed particularly to the shareholders derivative action to recover for misdeeds of corporate officials, cannot, even if so perhaps intended, override the direct mandate of §16(b), that suit may be brought 'by the owner of any security' without qualification. Pellegrino v. Nesbit, 9 Cir., 203 F. 2d 463; Park & Tilford, Inc. v. Schulte, 2 Cir., 160 F. 2d 984, certiorari denied Schulte v. Park & Tilford, Inc., 332 U.S. 761, 68 S. Ct. 64, 92 L. Ed. 347; Kogan v. Schulte, D.C.S. D.N.Y., 61 F. Supp. 604."

It is not clear whether the court based its decision on the inefficacy of the Rule-Making Statute to repeal the specific provisions of a conflicting statute, or on some other ground. However, we do not reach that question because we hold that there is no conflict between the rule and the law.

Appellant alleged a cause of action under the applicable section of the Securities Exchange Act, and it was error for the court to dismiss his complaint. The judgment is

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6 Blau v. Mission Corp., 2 Cir., 212 F. 2d 77.

FILED
APR 13 1956
HAROLD B. WILLEY, C

IN THE

Supreme Court of the United States

OCTOBER TERM 1955

NO. 799

CLINT W. MURCHISON, JR., ET AL., *Petitioners*,

VERSUS

MARK DOTTENHEIM, *Respondent*

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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AND
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SECURITIES AND EXCHANGE ACT OF 1934

15 U.S.C. Sec. 78c(a) 3(a)(10) 8

15 U.S.C. Sec. 78p(b) 3

Rule Making Statute, 28 U.S.C. (1927) Sec. 723b; Now 28 U.S.C. (1948) Sec. 2072 12

IN THE

Supreme Court of the United States

OCTOBER TERM 1955

NO. 799

CLINT W. MURCHISON, JR., ET AL., *Petitioners,*

VERSUS

MARK DOTTENHEIM, *Respondent*

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioners seek a writ of certiorari to review a decision of the United States Court of Appeals for the Fifth Circuit which unanimously reversed a judgment of the District Court for Northern Texas dismissing the complaint for legal insufficiency.

The decision below was interlocutory. Certiorari "is and generally should be issued only after a final decree"; *Panama R. Co. v. Napier Shipping Co.*, 166 U.S. 280, 284 (1897). The review of interlocutory decisions is allowed only where "necessary to prevent extraordinary inconvenience and embarrassment in the conduct of the cause"; *American Construction Co. v. Jacksonville T. & K. W. R. Co.*, 148 U.S. 372, 384 (1893). No such extraordinary circumstances have been shown. On the contrary, if petitioners should ultimately be held to be free of substantive liability, the action will be dismissed and the legal issues now presented to this Court will be academic.

We shall demonstrate that the decision below is not only intrinsically sound, but is in accord with the holdings of the Courts of Appeals for the Second and Ninth Circuits; with the holdings of the District Court for Southern New York; and with the views of all text writers who have considered the question.

Question Presented.

The three questions formulated by petitioners (Pet. 2-3) are inapposite because they evade what petitioners themselves describe as "the basic issue" (Pet. 7-8). The case presents only one question:

> In an action under § 16(b) of the Securities Exchange Act of 1934, must the plaintiff security

holder allege - as provided in Rule 23(b) F.R.C.P. - that he was a shareholder at the time of the transaction of which he complains?

Statutes and Rules Involved.

The text of the statutes and rules involved in this case is set forth at pages 3-7 of the Petition.

Statement.

This action was brought by respondent, a stockholder of Kirby Petroleum Company, to recover, on Kirby's behalf, insiders' short-swing profits which petitioners, defendants below, had realized in violation of § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p (b).

Upon petitioners' motion, the District Court dismissed the complaint on the ground that it failed to allege, as provided in Rule 23(b) F.R.C.P., that plaintiff was a stockholder of Kirby at the time of the transaction of which he complains.[1] 131 F. Supp. 790.

The Court of Appeals reversed, 227 F. 2d 737. It held that Rule 23(b) does not apply to a security holder's action brought pursuant to § 16(b). The Court below, quoting from earlier authorities, noted that § 16(b) permits suit by "the owner of *any* security", which includes the

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(1) An additional ground of dismissal - the alleged lack of verification of the complaint - was abandoned by petitioners in their brief on appeal below.

owner of recently acquired stock. The right of action under 16(b) "was primarily intended as an instrument of statutory policy of which the general public is the ultimate beneficiary. Congress did not intend procedural restrictions to hamper such policy." 227 F. 2d, at 740, fn. 4 and 5.

The Court below also rejected petitioners' argument that the promulgation of Rule 23(b) in 1938 superseded the earlier enacted § 16(b). The Court held that Rule 23(b) deals with the traditional stockholder's derivative action which is an invention of equity (227 F. 2d, at 739). On the other hand, § 16(b) "created a new cause of action which, while similar in some respects to a secondary or derivative right", is "neither derivative nor secondary in the sense in which that term is used in the Rule" (227 F. 2d, at 738, 739). Since the statute and the Rule thus deal with different subject matters, "there is no conflict between the rule and the law". Both are effective within their respective spheres of application.

Questions Not Presented.

Petitioners ascribe to the Court below a holding that Rule 23(b) applies only in diversity of citizenship cases (Pet. 9, 13); and they ask this Court to decide whether the Rule should be so limited (Pet. 2, Question "1").

The question thus posed by petitioners is wholly inapposite. The Court below did *not* hold that Rule 23(b)

is limited to diversity cases. It merely held that a security holder's action under § 16(b) is not the type of suit envisaged by the Rule. The broad question formulated by petitioners is therefore not involved in the case at bar.

Equally inapposite is petitioners' lengthy discussion (Pet. 9-21) whether the Rule 23(b) requirement of stock ownership at the time of the wrong is substantive or procedural in nature. That discussion might become relevant in a diversity case where it might be argued that the doctrine of *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938), compels a federal court to follow the substantive law of the State even though it be incompatible with Rule 23 (b).[1] In this case, however, the problem does not arise. Jurisdiction is *not* based on diversity of citizenship; the *Erie-Tompkins* doctrine is therefore inapplicable. Petitioner's extensive argument of this question is but a transparent attempt to arouse this Court's interest in a pretended issue which has actually nothing to do with this case.

Whether the "endless confusion and complexity surrounding Rule 23(b)", claimed by Petitioners (Pet. 17), is real or fancied is not a matter for consideration here; for, as we now proceed to show, *all authorities* agree, without contradiction, that a § 16(b) plaintiff need not allege stock ownership at the time of the transaction complained of.

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(1) See 3 Moore's Fed. Pr. (2d Ed.), Sec. 23.15(2), pp. 3493 et seq.

REASONS FOR DENYING THE WRIT

I.

THE DECISION IS IN ACCORD WITH THE UNANIMOUS HOLDINGS OF ALL AUTHORITIES.

Rule 23(b) F.R.C.P. provides that the complaint in a stockholder's derivative action shall allege "that the plaintiff was a shareholder at the time of the transaction of which he complains". The Court below held that this requirement does not apply to an action brought by a security holder under § 16(b) of the Exchange Act. All the authorities which have considered the question are in agreement with this holding:

Blau v. Mission Corp., 212 F. 2d 77, 79 (C.A. 2, 1954), cert. den. 347 U.S. 1016;

Pellegrino v. Nesbit, 203 F. 2d 463, 466 (C.A. 9, 1953);

Benisch v. Cameron, 81 F. Supp. 882, 884 (D.C., S.D.N.Y., 1948);

Kogan v. Schulte, 61 F. Supp. 604, 610 (D.C., S.D. N.Y., 1945);

Magida v. Continental Can Co., Inc., CCH Fed. Sec. L. Rep., vol. 4, par. 90725, pp. 92225, 92228 (D.C., S.D.N.Y., Op. of Aug. 3, 1955);

Rubin and Feldman, Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders, 95 Univ. Penn. L. Rev. (1947), 468, 473-4;

Cook and Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev. (1953), 385, 411;

Note, 62 Harv. L. Rev. (1949), 1071;

Note, 40 A.L.R. 2d 1346, 1358 (1955);

Loss, Securities Regulation (1951), p. 566;

3 *Moore's Fed. Pr.* (2d Ed.), 1955 Supp., par. 23.18, p. 146.

We respectfully call the Court's special attention to the careful reasoning in the article by *Rubin and Feldman, supra*, and in the District Court's decision in *Benisch, supra*. The grounds there set forth are the fountainhead for the later decisions in *Pellegrino, supra*, in *Blau, supra*, and in the decision of the Court below. Petitioner's brief completely ignores these arguments.

II.

THE LANGUAGE AND PURPOSE OF § 16(b) OF THE EXCHANGE ACT PRECLUDE THE APPLICATION OF RULE 23(b) F.R.C.P.

1. Petitioners contend that the security holder's action authorized by § 16(b) of the Exchange Act is nothing

more nor less than the shareholder's secondary or derivative action which is regulated by Rule 23(b) F.R.C.P. Petitioners deduce from that premise that the § 16(b) action brought by a security holder is subject to all the requirements of Rule 23(b). The contention, we submit, is altogether untenable.

§ 16(b) and Rule 23(b) deal with different subject matters. Rule 23(b) regulates the conventional stockholder's derivative action which may be brought on equitable grounds where the corporate management improperly fails or refuses to enforce a claim belonging to the corporation. This action is a creature of equity; and Rule 23 (b) defines the conditions under which it may be maintained.

Otherwise is the security holder's action under § 16(b). It is a statutory creature. It can be brought not only by a shareholder, but by "the owner of any security of the issuer"; and under the broad statutory definition[1], the term "security" includes bonds and debentures. A bondholder or a debenture holder can thus qualify as plaintiff under § 16(b). Since such a plaintiff cannot allege that he was a "shareholder" at the time of the wrong, it is plain that such an allegation is not necessary in a § 16 (b) action.

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(1) Sec. 3(a)(10) of the Exchange Act, 15 U.S.C. Sec. 78c(a)(10) provides:

"The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing

Nor is this all. Rule 23(b) requires the plaintiff in a conventional stockholder's derivative action to set forth with particularity his efforts to secure from the directors and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action, or the reasons for not making such effort. By contrast, a § 16(b) plaintiff need allege no more than that he requested the corporation to bring suit and that it failed to do so within sixty days thereafter.

It is thus clear that § 16(b) not only created a new cause of action, but that it prescribed at the same time its own code of procedural prerequisites by which the new statutory cause of action was to be governed.

Plainly it would be impossible to superimpose the requirements of Rule 23(b) upon the statutory scheme of § 16(b). The Rule deals only with shareholders, while the statute applies to the owner of *any* security. The Rule

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agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

requires the complete exhaustion of all intra-corporate remedies, together with a statement of the reasons for their failure; the statute is satisfied with a demand which remains unsatisfied for sixty days. Any attempt to write Rule 23(b) into § 16(b) would destroy the carefully devised plan of the statute.

2. § 16(b), as we have said, permits suit by "the owner of *any* security". The statute thus does not distinguish between securities recently acquired and those held at the time of the transaction complained of. The holder of either kind of security may bring the action.

Congress had a valid reason for discarding any distinction between recent security holders and those of long standing. The fundamental purpose of § 16(b) is to compel the surrender of insiders' short-swing profits. But the insiders, holding the control of the corporation, could not be expected to enforce the statute against themselves. To put teeth into the statute, its enforcement had to be entrusted to others; and this watch dog class had to be sufficiently broad and numerous to assure the likelihood that violations would be detected and corrected. Hence it is that the statute enlists *all* security holders as agents for its enforcement, regardless of the peculiar interest which may be present or absent in the person of any individual security holder.

That such is the underlying purpose of § 16(b) is evidenced by the fact that even a mere debenture holder is authorized to bring the suit. The ordinary "shareholder's suit in essence is nothing more than a suit by a beneficiary of a fiduciary to enforce a right running to the fiduciary as such"; *Goldstein v. Groesbeck*, 142 F. 2d 422, 425 (C.A. 2, 1944), cert. den. 323 U.S. 737. In other words, a stockholder's right to bring the traditional derivative suit rests upon his equitable or beneficial interest in the claims belonging to his corporation. But a debenture holder is a simple creditor; he has no equitable or beneficial interest in the corporate assets; and his claim against the corporation (if it is solvent) is not enhanced or improved if insiders' short-swing profits are channelled into the treasury of the corporation. Nevertheless, § 16(b) permits suit by a debenture holder. That is clear evidence that the statute uses the security holders merely as instruments to effectuate its fundamental policy.

Since Congress thus reached out to qualify even a mere debenture holder as plaintiff under § 16(b), it follows *a fortiori* that a holder of recently acquired stock is equally qualified. The language of § 16(b) - giving the right to sue to "the owner of *any* security" - is certainly broad enough to include the owner of recently acquired stock; and such a stockholder can perform the statutory function of enforcing § 16(b) claims quite as affectively as a security holder of long standing. Neither the language nor

the purpose of the statute thus affords any basis for the distinction which petitioners advocate.

III.

THE PROMULGATION OF RULE 23(b) DID NOT OPERATE AS A PARTIAL REPEAL OF § 16(b).

§ 16(b) was enacted in 1934. Rule 23(b) was promulgated in 1938 as part of the Federal Rules of Civil Procedure. The Rule-Making-Statute[1] provides that "all laws in conflict with such rules shall be of no further force or effect after such rules have taken effect."

Petitioners contend that Rule 23(b) is in conflict with § 16(b) and that, to the extent of such conflict, the statute was repealed by the Rule. If the contention were to be sustained, its effect would be grave indeed. In enacting § 16(b), Congress intended to give the right of action to any security holder; Rule 23(b) would now restrict that right to stockholders. In enacting § 16(b), Congress did not differentiate between security holders of recent vintage and those of long standing; Rule 23(b) would now import that distinction into the statute. In enacting § 16(b), Congress intended to give the security holders an absolute right of action after a sixty days' waiting period; Rule 23(b) would now require the complete exhaustion of all intracorporate remedies before the action

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(1) 28 U.S.C. (1927), Sec. 723b; now 28 U.S.C. (1948), Sec. 2072.

can be brought. In short, petitioners contend that the adoption of Rule 23(b) by this Court was designed completely to eliminate the procedural scheme so carefully drawn by Congress in enacting § 16(b).

Fortunately, it is unnecessary to draw the extreme conclusions which petitioners advocate. Petitioners' contention that Rule 23 repeals any part of § 16(b) is untenable.

1. The Rule-Making-Statute, *supra*, presupposes a conflict between the Rule and an earlier statute. The Court below properly held that there exists no conflict between Rule 23(b) and § 16(b). Rule 23(b) as we have said, deals with the conventional stockholder's action created by equity. § 16(b), on the other hand, created an entirely new procedural device, namely, a security holder's action. As we have shown, § 16(b) authorizes suits not only by the owners of stock, but also by the owners of bonds, debentures, or other securities. These security holders are authorized to sue under § 16(b), not because they have an equitable interest in the corporate assets - the holders of bonds or debentures have no such equitable interest - but because Congress, for the reasons already stated, saw fit to give them this right. Rule 23(b) was not designed to deal with such a security holder's action of purely statutory origin. There is, therefore, no conflict between the two provisions; each of them is and remains applicable within its own field of operation.

2. But let it be assumed, for argument's sake, that there exists a conflict between § 16(b) and Rule 23(b). Even so the origin and history of Rule 23(b) make it plain that the Rule was not designed to supersede § 16(b).

Although Rule 23(b) went into effect in 1938, it was nothing but a continuation of Equity Rule 27 (198 Fed. XXV) which, in turn, was a continuation of Equity Rule 94 (104 U.S. IX). See 3 *Moore's Fed. Pr.* (2d Ed., 1948), par. 23.01, p. 3406. As stated in the *Official Committee Note of 1946* to Rule 23(b) F.R.C.P.:

> "The provision in Equity Rule 94 was later embodied in Equity Rule 27, of which the present Rule 23 is substantially a copy."

Equity Rule 94 dates back to 1882. In 1913 it was replaced by Equity Rule 27. Both Rules thus predated § 16(b) of the Exchange Act by many years. There can be no question but that, upon the enactment of the Exchange Act in 1934, the provisions of its § 16(b) superseded any inconsistent provisions of Equity Rule 27. Petitioners themselves do not deny that, from 1934 until at least 1938, § 16(b) was in full force and effect as written and that Equity Rule 27 was inapplicable to actions under § 16(b).

Was this state of the law changed by the promulgation of the Federal Rules of Civil Procedure in 1938? There is absolutely nothing in the Federal Rules to indicate such an intention. Rule 23(b) is but a reenactment, with

minor verbal changes, of Equity Rule 27. It is inconceivable that this reenactment - consisting of little more than a renumbering - should have been intended to achieve the repeal by implication of important parts of § 16(b) of the Exchange Act.

We have but recently been reminded of the "cardinal principle of construction that repeals by implication are not favored. When there are two acts upon the same subject, the rule is to give effect to both if possible * * * The intention of the legislature to repeal 'must be clear and manifest.'" *Rosenberg v. United States*, 346 U.S. 273, 294 (1953). There is not one word in the Rules themselves or in the underlying legislative materials to suggest that Rule 23(b) was to have a broader sweep than its predecessor, Equity Rule 27. Since Equity Rule 27 was inapplicable to actions under § 16(b), its successor Rule 23(b) is equally inapplicable. Any contrary view would run afoul of the elementary principle that "reenacted sections are to be given the same meaning they had in the original statute, unless a contrary intention is plainly manifested"; *United States v. LeBris*, 121 U.S. 278, 280 (1887); *Heald v. District of Columbia*, 254 U.S. 20, 23 (1920).

3. The same conclusion is fortified by an additional ground. It is an elementary principle that special legislation, dealing specifically with a narrow subject (such as actions for short-swing profits of corporate insiders),

is not to be deemed repealed by later general legislation dealing broadly with a general subject (such as stockholders' actions), although the general subject may encompass the special. As was held in *Washington v. Miller*, 235 U.S. 422, 428 (1914):

> "* * * where there are two statutes upon the same subject, the earlier being special and the later general, the presumption is, in the absence of an express repeal, or an absolute incompatibility, that the special is intended to remain in force as an exception to the general (citing authorities)."

Accord:

Rogers v. United States, 185 U.S. 83, 87-89 (1902);

Commissioner v. Rivera's Estate, 214 F. 2d 60, 63 (C.A. 2, 1954);

Home Owners Loan Corp. v. Creed, 108 F. 2d 153, 155 (C.A. 5, 1939).

In the application of this principle it makes no difference that the later general statute contains a clause expressly repealing all earlier inconsistent statutes; *Great Northern R. Co. v. United States*, 155 Fed. 945, 947 (C.A. 8, 1907), aff'd 208 U.S. 452; *Hoague-Sprague Corp. v. Frank C. Meyer Co.*, 31 F. 2d 583, 585-6 (D.C., E.D.N.Y., 1929).

The rule is based on solid reason. Take its application to the case at bar. A legislative body - here, this Court and Congress - proceeds to regulate the general subject

of stockholders' actions. It finds that the provisions theretofore in effect are adequate and so it reenacts them. But its attention is not focused on the special subject of § 16(b) actions. Congress has previously determined that this specific type of litigation is subject to peculiar policy considerations requiring regulation different from that governing the run-of-the mill stockholders' actions. This Congressional determination is as valid now as it was then. There is no indication that this Court, in enacting Rule 23(b), gave any thought to the special problems surrounding actions under § 16(b). There is no indication that this Court intended to re-evaluate and to reverse the judgment of the Congress embodied in § 16(b). This Court dealt only with the general subject of stockholders' leaving unaffected the special subject of security holders' actions for the recovery of short-swing profits of corporate insiders. Under the sound principle of *Washington v. Miller, supra*, and the authorities cited, the special provisions of § 16(b) are not repealed by the later general regulation contained in Rule 23(b); the special provisions of § 16(b) remain in force as an exception to the general provisions of Rule 23(b).

CONCLUSION

We submit that the decision below is sound; and it is in accordance with all of the numerous and uncontradicted authorities we have cited. By moving to dismiss the complaint for legal insufficiency, petitioners admitted the

truth of its charges. They seek to escape liability not by attempting to justify their conduct, but by a personal attack upon the plaintiff. To permit such an attack would undermine the salutary policy of the statute and would permit defendants to go scot-free. It is respectfully submitted that the petition should be denied.

Dated:

April 12, 1956

Respectfully submitted,

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HAROLD B. SANDERS, SR.

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AFFIDAVIT OF SERVICE OF RESPONDENT'S BRIEF IN OPPOSITION FOR WRIT OF CERTIORARI

BEFOLE ME, the undersigned authority, a Notary Public in and for Dallas County, Texas, on this day personally appeared Harold Barefoot Sanders, Jr., who, being by me duly sworn, upon his oath deposes and says that on the ——— day of April, 1956, he delivered to Hon. Franklin E. Spafford and Hon. Donald G. Gay, 1310 Kirby Building, Dallas, Texas, attorneys for Petitioners in the above cause, a true copy of the foregoing brief in opposition to writ of certiorari to the United States Court of Appeals for the Fifth Circuit.

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Harold Barefoot Sanders, Jr.

Subscribed and sworn to before me by the said Harold Barefoot Sanders, Jr., this ——— day of April, 1956, to certify which witness my hand and seal of office.

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Notary Public in and for Dallas County, Texas.